



# Memorandum

**TO:** COMMUNITY AND ECONOMIC  
DEVELOPMENT COMMITTEE

**FROM:** Paul Krutko

**SUBJECT:** See Below

**DATE:** May 2, 2007

---

**COUNCIL DISTRICT:** City-Wide

**SUBJECT:** Approval of a work plan for the proposed Sales/Use Tax Strategy known as the Business Cooperation Program

## **RECOMMENDATION**

It is recommended that the Community and Economic Development Committee approve the proposed work plan for a Business Cooperation Program for sales and use tax in order to generate new revenue for the City.

## **OUTCOME**

The desired outcome is the adoption of a work plan for business sales/use tax collection that would include hiring a consultant to provide detailed technical expertise to the City. The consultant would work with local companies to allocate Sales/Use tax back to San Jose, thereby increasing general fund revenue to the City.

## **BACKGROUND**

Approximately one fifth of the City's General Fund tax revenue comes from sales/use tax. The Office of Economic Development (OED) is proposing a Sales and Use Tax program that would allow the City to increase general fund revenue. When taxable transactions occur in California, sales tax is applied. When taxable purchases occur out of state for consumption in California use tax is applied. Use Tax is collected when entities in California make purchases of fixtures, tools, machinery and building supplies from out-of-state companies. Often, out-of-state retailers do not have reasonable means to determine which jurisdiction the goods are shipped to and where the first functional use occurs; as a result, use tax is allocated to county and state pools rather than the City. These "pools" are pots of tax money that are to be allocated to a local jurisdiction, unlike a traditional retail sale in California where the point of sale is easily determined and the local portion of the tax revenue is able to flow back to the local jurisdiction. In order for the State Board of Equalization (SBOE) to distribute the money from these pools, they use a pro-rata formula to determine how much each jurisdiction gets from each of the pools. The allocation to San Jose from

the statewide pool is, on average, 2-3% and from the countywide pool, 43%. This translates to 2 cents on the dollar and 43 cents on the dollar, respectively.

The State of California through various legislative and board resolutions created two mechanisms to better allocate use tax among California jurisdictions. A first avenue is the Direct Pay permit. For instance, companies that consistently purchase equipment, and fixtures in an aggregate of \$500,000 a year use a special Direct Pay Permit which can be requested from the State that allows the buyer instead of the seller to allocate the use tax collected. Once again, the common practice is the out-of-state seller collects the use tax and then remits monies back to California. With the Direct Pay Permit, the buyer self-accrues the use tax and then remits the use tax with the full 1% local allocation going to the local jurisdiction (Tax Code §7051.3). Currently, in California, there are 136 such permits, 44 held by private companies and 92 held by local taxing jurisdictions. The City of San Jose took the lead and was the first city in California to hold a Direct Pay permit.

A second avenue exists for the allocation of use tax. The SBOE made a provision that allows for use tax to be allocated to local jurisdictions in the case of construction contracting. Through the construction company's sellers permit, construction purchases of equipment and fixtures of \$5 million or more residing at the job site can have use tax from those purchases allocated to the job site. Through tax forms issued by the SBOE a firm can assume the tax liability, self-accrue the tax, and then report the collection of the tax to the state, thereby allocating the use tax back to the jurisdiction where the equipment and fixtures will reside. (Sales and Use Tax Regulation 1521). To reiterate, the common practice for out-of-state purchases is for the seller of the good to report the tax back to the State of California, not the buyer.

## **ANALYSIS**

OED is proposing a work plan for a Business Cooperation Program (BCP) that would aid in recapturing the full 1% of Use Tax revenue on selected projects. The approach is very similar to what other cities are currently doing. Many cities in Southern California have adopted programs to help recapture the use tax back to their local jurisdictions. These cities are: San Diego, Ontario, Long Beach, Newport Beach, El Segundo, Tulare and Los Angeles.

Each city has implemented different programs to regain some use tax revenue. The most common use tax program implemented is encouraging companies to obtain Direct Pay Permits. The SBOE will provide a Direct Pay Permit to any business that has more than \$500,000 in use tax revenue in the immediately preceding calendar year. This permit is revocable at any time. This Permit allows the buyer to accrue the use tax instead of the seller and report it to the SBOE thereby allocating to the local jurisdiction. As encouragement to businesses that use Direct Pay Permits, many of the cities that use this as their primary tool offer a rebate of at least 10% net new revenue on the additional use tax collected. For instance, City of Los Angeles encourages businesses to obtain a Direct Pay Permit and upon doing so, the City of Los Angeles will offer businesses a rebate of 20% on the additional net new Use Tax collected by the SBOE.

Since Use Tax reporting and collection is a complicated process for businesses, Cities implement the use tax program differently. For instance San Diego uses the following incentives:

- A cash rebate equal to .25/dollar (25 basis points on the total sale or purchase price)

- A business tax/development fee credit equal to .45/dollar (45 basis points on the total sale or purchase price). Participating firms can pay their annual business license tax and/or fees arising from new facility development with credit earned by allocating their taxes to the City. Firms which choose this option can "cash in" any unused credit at a later time.

Because the cities receive consideration, in the form of increased/use tax revenue, for actions undertaken by a business that it would not otherwise do, such an incentive would be appropriate. Other cities hire consultants who work closely with companies to help allocate the use tax. Because the paperwork and the collection of receipts can be tedious cities have found it useful to be able to provide consultant services to aid in the report process for firms.

The City of San Jose is seeking to create a Business Cooperation Program (BCP) that will provide an incentive and assistance for companies to incur the costs of participating in the program. OED has found through it's own experience in working with companies that the amount of oversight a company has to have to successfully allocate use tax comes at a significant cost. Local companies are receptive to the idea of having an incentive to participate.

To achieve this, the City is seeking third-party specialized expertise from a use tax consultant to help identify, structure and assist San Jose companies with accruing tax liability. The primary role of the consultant will be to provide technical assistance to participating companies in the monitoring and accruing of eligible purchases. As is customary for this type of work, consultant fees are traditionally determined by the amount of net new revenue they are successful in capturing. These fees are traditionally established on some percentage basis of net new sales tax revenue. The City would be capping the percentage and amount of the contract.

Working with the Consultant, Attorney's Office and Finance Department, OED would work on developing boilerplate Use Tax sharing agreements. The Use Tax sharing agreement would be the incentive for the business to participate. A portion, yet to be determined, of the new tax revenue would be shared with the company to cover the increased administrative burden. A specific workplan for the implementation of the Use Tax agreements as well as the boilerplate agreements would be brought to the Community & Economic Development Committee for additional consideration and approval. Within this specific workplan, annual reports to council on the status of all agreements would be detailed.

The next steps for the proposed work plan are:

- Issue a Request for Proposals
- Enter into a contractual agreement with a successful bidder
- Develop a specific work plan for Use Tax Sharing Agreements
- Develop Boilerplate Use Tax sharing agreements
- Bring the specific work plan and Boilerplate Use Tax sharing agreements to Community & Economic Development Committee for consideration.

## **POLICY ALTERNATIVES**

***Alternative #1:*** The City could choose to not to accept a work plan for a Business Cooperation Program and the hiring of a consultant.

**Pros:** The City would continue to receive state and county pool revenue through the current process.

**Cons:** The City is losing the opportunity to collect the full 1% use tax revenue on purchases, fixtures, fabrication of equipment used in San Jose.

**Reason for not recommending:** The policy alternative continues to leave revenue in countywide and state pools that could be captured directly in the City.

**Alternative #2:** The City could choose not to offer any incentives to businesses that are willing to participate undertaking the burden allocating use tax in San Jose.

**Pros:** The City would be able to retain a greater share of the revenue if companies do participate.

**Cons:** Unable to determine if any companies would be willing to accept the additional burden required to allocate use tax without an incentive. Based upon our experience and research with other jurisdictions, without compensation participation from companies has been non-receptive to take on additional workloads.

**Reason for not recommending:** The policy alternative provides a benefit to the City while imposing greater administrative costs on companies, our research suggests companies would not participate and therefore no additional revenue would be recognized from the program.

## **PUBLIC OUTREACH/INTEREST**

- ☐ **Criteria 1:** Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**
- ✓ **Criteria 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- ☐ **Criteria 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

Economic Development will be issuing a Request for Proposals (RFP), the RFP will be cross-posted on the websites for the City and OED. After the completion of a successful RFP process, OED will bring back to the Community & Economic Development Committee a detailed workplan on the implementation of the Use Tax Agreements.

## **COORDINATION**

This memo has been coordinated with the City Attorney's Office, Budget Office, City Auditor, Sacramento Legislative Office and Finance Department.

## **FISCAL/POLICY ALIGNMENT**

These actions further the vision of San Jose as the world's most livable city contained in the Economic Development Strategy to "Develop Retail to Full Potential, Maximizing Revenue Impact and Neighborhood Livability." (Initiative 13).

May 2, 2007

**Subject:** Business Cooperation Program

Page 5

**COST SUMMARY/IMPLICATIONS**

The compensation for the consultant will be determined by a percentage of net new revenue resulting from the work. The percentage and total amount will be capped in the contract.

**CEQA**

CEQA: Exempt

PAUL KRUTKO  
Chief Development Officer  
City Managers Office

For questions please contact Paul Krutko, Chief Development Officer at 408-535-8182.